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SIPDIS

DEPARTMENT PASS TO EUR/WE

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TAGS: EPET ENRG PGOV SP
SUBJECT: SPAIN: GROWING PAINS IN LIBERALIZED NATURAL GAS
MARKET

REF: A. 04 MADRID 04241
¶B. 05 MADRID 00393
¶C. 04 MADRID 04613

¶1. SUMMARY: Rapid growth in domestic consumption has made Spain the world's fifth largest natural gas market. Market liberalization, combined with growing demand and environmental concerns, has given rise to potential supply problems that could jeopardize Spain's energy grid. Spain is strengthening its natural gas infrastructure to prevent distribution problems and to lower prices, and Spanish companies are pursuing development opportunities with new suppliers. However, neither effort will likely impact the long-term problems that Spain currently faces. Alternate fuels are not feasible due to political or technological reasons and it appears that the GOS will likely have no choice but to raise current ceilings on natural gas prices. This could cause difficulties for the Socialist government, as higher natural gas and energy prices would negatively affect their social agenda and have an inflationary impact on the Spanish economy. END SUMMARY

MARKET OVERVIEW

¶2. Spain has been undergoing a steady privatization of its energy sector over the past eight years, with the goal of attaining full liberalization by 2013. Meanwhile, energy consumption has skyrocketed due to strong economic development, causing Spain to search for additional inexpensive energy sources. At the same time, Spain is struggling to meet its EU and Kyoto Protocol commitments to reduce CO2 emissions. Spain's emissions in 2004 were 45 percent over 1990 levels, which is three times Madrid's quota under the terms of the Kyoto Protocol. This situation has necessitated the use of cleaner fuels. As a result, Spain has increasingly relied on combined-cycle electricity generators, which are fueled by natural gas. At this time, there are twelve such generators in Spain, with ten new plants projected to come on-line in 2005. This increased demand has caused Spain to become the world's fifth largest market for natural gas.

¶3. Natural gas provides more than 15 percent of Spanish energy, already surpassing coal, and consumption increased by 16.8 percent in 2004, to a total consumption of 321,617 GWh. Of that total, 248,434 GWh was sold in the industrial/household/commercial market, an increase of 8.39 percent over the previous year. However, power generation was the market with the strongest growth, consuming 67,497 GWh. This figure represents a growth of 68.5 percent over 2003 and accounts for 21 percent of the total natural gas consumption in Spain.

¶4. Spain imports 98.3 percent of its natural gas, with total natural gas imports experiencing an increase of 15 percent over 2003. Spain's largest supplier is Algeria, which accounted for 51.5 percent of imports in 2004, down from 58.5 percent in 2003. The Persian Gulf countries of UAE, Qatar and Oman have emerged as Spain's second largest suppliers, providing 19.4 percent of imports. Of note, Persian Gulf imports increased from 29,227 GWh in 2003 to 61,700 GWh in 2004, an increase of over 111 percent. Nigeria is Spain's third largest supplier at 16 percent of total imports, with Norway rounding out the main suppliers with 10 percent.

¶5. The GOS plays an important regulatory role in the energy sector. Government regulations dictate that no one country can provide more than 60 percent of Spain's natural gas imports and that energy suppliers must maintain a thirty-day reserve supply of fuel. The government also sets a cap on energy and natural gas prices that is reviewed on a monthly basis. In 2004, the Spanish government imposed a decrease of one percent in consumer gas prices in April, and increases of 2.6 percent each in July and October. A separate governmental institution, the National Energy Commission (CNE), maintains the responsibility to ensure that the industry is in compliance with government regulations by conducting inspections, preparing sector reports and engaging in dispute resolution. In addition, the Ministry of Industry has established a ten-year plan, effective from the years 2000 through 2011, which sets goals in regard to the sources of final energy consumption. The plan calls for average

annual increases of 9 and 10 percent in natural gas and renewable energy, respectively, and a 3.66 percent average annual decrease in the use of coal.

THE MAJOR PLAYERS

¶6. The main players in the Spanish natural gas market are Gas Natural, Repsol YPF, Cepsa, and Enagas. Gas Natural is the largest supplier of natural gas and, prior to liberalization, it controlled nearly all aspects of the natural gas market. Repsol YPF and Cepsa also maintain strong market shares, although they both primarily operate in the petroleum market. Enagas is the main Spanish company responsible for transport, regassification and storage of natural gas. It also holds sole responsibility for the distribution of natural gas, coordinating transportation of natural gas supplies among access points and storage sites. As is common at the intertwined commanding heights of the Spanish economy, Repsol YPF holds a 30.8 percent share of Gas Natural, while Gas Natural maintains a 26.1 percent share of Enagas. The CNE has intervened in this aspect of the natural gas market, issuing a decree that limits the economic holdings of any one company in Enagas to 5 percent. Gas Natural sold off 12.5 percent of its share in the grid operator in 2004, with further reductions planned to bring the company in compliance.

¶7. The Spanish banking sector maintains a strong interest in the energy market, maintaining significant holdings in natural gas providers: Repsol YPF (17.8 percent), Cepsa (45.5 percent) and Gas Natural (39.8 percent); as well as electricity suppliers: Endesa (13.6 percent), Iberdrola (14.7 percent) and Union Fenosa (30.3 percent). The dominant banks in this area are La Caixa, which maintains 12.5 percent of Repsol YPF and 33.8 percent of Gas Natural, and Santander, which maintains 45.5 percent of Cepsa and 23.3 percent of Union Fenosa.

INFRASTRUCTURE

¶8. Spain imports its natural gas via boat and pipeline, with each accounting for approximately 50 percent of imports. Liquid natural gas arriving in Spain via boat is processed in one of four regassification centers: Barcelona, Cartagena, Bilbao, and Huelva. New centers are currently being built in Ferrol, Sines and Sagunto, while existing centers in Huelva and Cartagena underwent significant upgrades to their storage tanks and increases in their distribution capacity in 2004. In 2005, Spain plans on increasing the storage tank capacity in both Cartagena and Barcelona, while improving distribution capacity in Huelva and Barcelona.

¶9. In 2004, Spain put 1,267 km of new pipelines into service, mostly to strengthen the internal distribution system. Gas arriving in Spain via pipelines used one of two existing systems: the Lacq-Calahorra pipeline, which connects Spain with France and facilitates the arrival of natural gas from Norway; and the Mahgreb pipeline, which connects Spain and Algeria by transiting through Morocco. In 2005, the GOS anticipates that approximately 1,000 km of new gas pipelines will be put into service and that two new compression stations (Cordoba and Crevillente) will become fully operational.

¶10. On 23 January 2005, Europe's newest gas pipeline was completed connecting Bilbao, Spain and Lussagnet, France. The 500 km long pipeline has a capacity of 500 million cubic meters of natural gas per year. It will primarily operate to export natural gas from Africa via Spain to the rest of Europe. The pipeline was a joint project between Gas de Euskadi (Spain) and Gaz du Sud Oest (France). It cost EUR 23 million, with the EU providing five percent of funding.

¶11. In 2006, construction will begin on the Medgaz pipeline, which will directly link Spain with Algeria. The pipeline will be 747 km long, with the capacity to move approximately 10 billion cubic meters of gas per year. Investors include: Cepsa (Spain) and Sonatech (Algeria) with a 20 percent share each; and Total (France), BP (Britain), Gaz de France, Iberdrola (Spain) and Endesa (Spain) with a 12 percent share each. The pipeline will cost an estimated EUR 1.1 billion and is due to be completed in 2009. Currently, the EU is studying the possibility that it could partially finance the project, as it would help alleviate the energy problems in other parts of Europe.

POTENTIAL PROBLEMS

¶12. Increasing demand has led to problems in the Spanish energy market. A possible weakness in the natural gas system was exposed in December, when Enagas was forced to reduce the gas supply to various petrochemical factories and three large electricity suppliers: Endesa, Iberdrola and Union Fenosa.

The reduction lasted from December 13 through December 18 and was attributed to damage to a gas compression station in Algeria, combined with a seasonal spike in demand. The companies affected have contracts with Enagas that afford them lower gas prices but which permit a justified interruption in service. The Spanish government became directly involved in this issue, chairing meetings between Enagas and the electricity suppliers. Ministry of Industry officials told Econoff that there had not been an emergency and that the situation had been over-publicized, despite the resulting brownouts that affected various portions of the country. Ministry sources further commented that the situation had been exacerbated by the closure of a nuclear power plant for renovations during that time period. Finally, they expressed confidence that renovations scheduled for 2005 will reduce the likelihood of a reoccurrence of the problem.

¶13. Market liberalization has also created a potential problem in regard to Spain's natural gas supply. The GOS sets a ceiling on the price of natural gas and electricity in Spain. With the privatization of the sector, Spanish natural gas importers are now free to pursue other markets for their products. An increasing amount of liquid natural gas, which could be delivered to Spain, is being diverted to the United States and Japan where companies can obtain higher profits. Ministry of Industry officials told Econoff that the amount actually being diverted is not sufficient to have a large impact on the Spanish market.

POTENTIAL SOLUTIONS

¶14. Spanish companies, such as Repsol YPF and Gas Natural, are attempting to develop new markets that could increase the supply of gas to Spain. In December, the two companies signed an agreement to conduct joint exploration and production of additional natural gas sites in Algeria. Combined with the future opening of the Medgaz pipeline, this move could help ease the developing supply problems by providing additional inexpensive sources. In addition to Algeria, Repsol YPF is currently in negotiations with Gazprom (Russia) for joint ventures to include: supplying natural gas to Spain, cooperation in exporting liquid natural gas to the United States, and joint development projects in third nations. Currently, Spain does not receive natural gas from Russia, the country with the world's largest reserves, due to the lack of sufficient capacity in existing European pipelines combined with the high cost of transportation across Europe. At this time, the two companies have created a working group to study concrete initiatives for joint operations. Finally, Repsol YPF has won the rights for exploration and development in Liberia, in the first tender ever run by the Liberian government to accept international bids. Of note, Repsol YPF did obtain the right to develop another block of Liberian territory in the summer of 2004, through direct negotiations with the Liberian government.

COMMENT

¶15. Rising demand and market liberalization are likely to put pressure on the Spanish government to take further action. The government will have two options in this situation: they can turn to other methods of supply or steadily increase the price ceiling on natural gas prices. Spain does have other options to provide energy, namely nuclear and coal, but both are politically undesirable. Nuclear, although clean and potentially sufficient for Spain's energy needs, is politically untenable due to strong public opinion against its use (see reftel A). Coal, abundant in Spain and relatively inexpensive, results in high pollution levels that would cause Spain to move further away from its Kyoto obligations (see reftel B and previous). The Kyoto Protocol mandates that Spanish CO_2 emission levels are 15 percent over 1990 levels by 2012. By the end of 2004, Spanish CO_2 emission levels were actually running at 45 percent over 1990 levels. Spain's Socialist government is determined to re-orient the country towards Europe, and making serious efforts to implement the Kyoto targets are widely viewed as a central part of the "return to Europe" strategy. In part due to Kyoto-related pressure, The GOS is encouraging the increased use of renewable energies, such as wind and solar power, but the technology is not sufficient at this time to meet market demand (see reftel C). These problems, combined with growing Spanish investment in natural gas infrastructure and power plants, indicate that Spain will increasingly rely on natural gas for its energy needs. As a result, the government will likely have to raise the price ceilings on natural gas in order to compete with other national markets. However, this solution will likely encounter strong resistance from Second Vice President and Minister of Finance Pedro Solbes, due to the resulting inflationary influence that it would exert upon the Spanish economy. This energy issue will likely evolve into a high profile problem that the Socialist government will have to address; balancing their social agenda with fiscal responsibilities and environmental

obligations.
MANZANARES